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"The Market as Interpreted under the Dow Theory"

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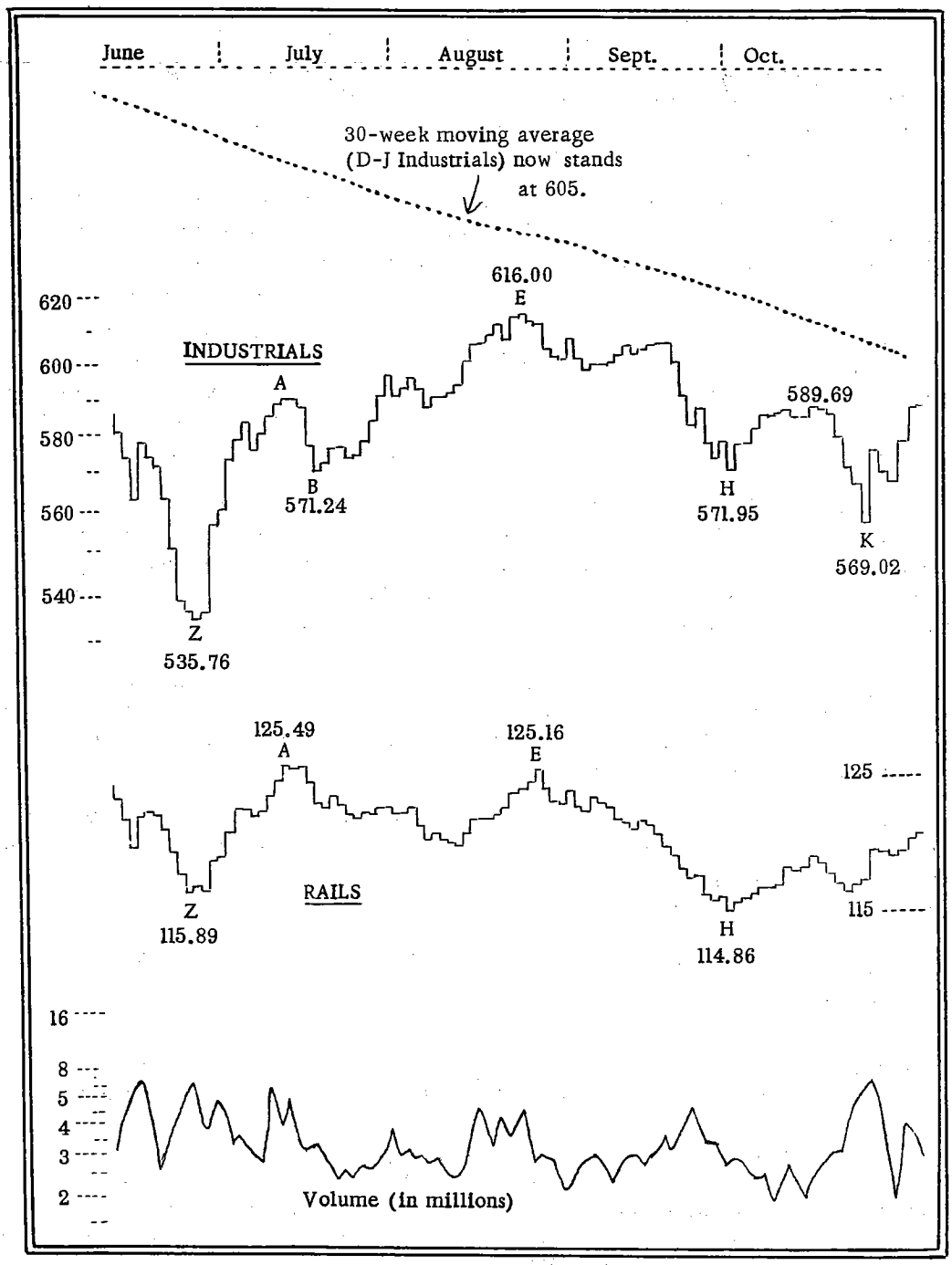
THE MARKET This Letter has been written on two levels: (1) orthodox Dow Theory and an analysis of the action of the Averages; (2) the relationship between the Industrial Average and the advance-decline ratio (A-D ratio). Although the latter study is, of course, no part of Dow Theory, it is one which I feel is both important and fundamental.

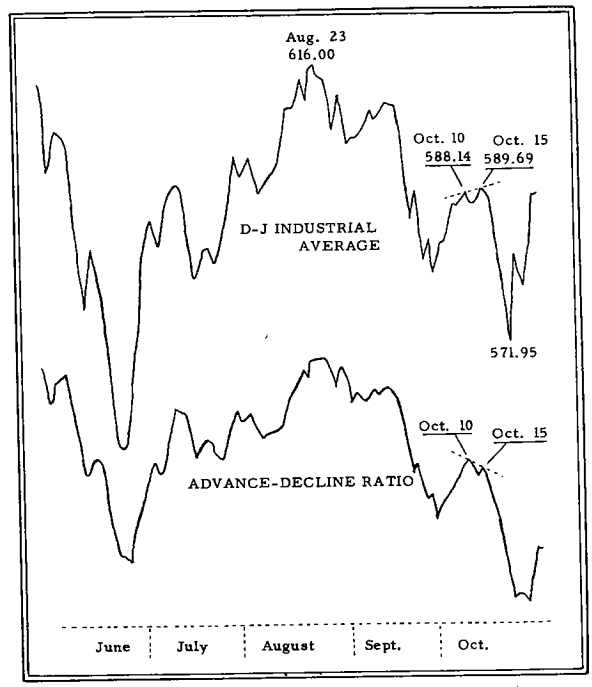
Letter 197 discussed the possibility of triple divergence between the Industrial Average and the A-D ratio. Industrials and the A-D ratio struck joint peaks on October 10 (Industrials at 588.14 -- see chart on page 2). A minor decline ensued, followed by a second Industrial recovery to 589.69 (October 15). This second recovery was not confirmed by the rest of the market as represented by the A-D ratio. Subsequent to the second recovery high, the news of the Cuban Blockade hit the market, and the resultant drop in the Industrial Average seemed to eliminate the possibility of a full triple-divergence.



The decline which followed the October 15 peak was so extensive, in fact, that the A-D ratio (on October 22) broke to a new bear market low (see Letter 198). A violent rally began on October 23. During the course of the next six days Industrials rallied toward the October 15 peak, and as the early part of this Letter is written (Wed., October 31, after the close) Industrials have ended the day at 589.77! This figure is exactly 8¢ above the October 15 closing, and we have now witnessed three successive highs on the Industrial Average together with three successively lower peaks on the A-D ratio. In the past, such technical action (although it is by no means infallible) has held extremely bearish implications for the general market.

AN "UNFETTERED" MIND A subscriber writes that "because of your short position, you must be subject to a continuing bearish bias." In

answer, I will state that during the past four months I have held no position of any kind. Moreover, I have never been convinced that a professional market soothsayer should assume a position (except, perhaps, an early long-term position during a bull market). My feelings are best explained by a paragraph which William P. Hamilton wrote thirty-five years ago:



"Any intelligent student of the Averages who has once grasped the principle of the stock market barometer can draw deductions for himself, provided he brings to the task a really unbiased mind. An interest in the stock market would be almost certain to weaken his judgment. It is only human to foresee what you hope and, indeed, what you expected when you bought stocks for the rise or sold them short. But the analyst of the price movement, writing for the guidance of others, must be absolutely disinterested. There are all sorts of traps to catch him if he is not, particularly if he has committed himself to inferences not clearly justified by the premises. Sheer pride of opinion has ruined more speculators in the stock market than all other causes put together."

As to a possible "bearish bent" in my character, nothing could be further from the truth. A bear market means a general contraction in business, whether that business is auto parts, security transactions or subscriptions to stock market services. An extended bear market means hardship for all (and the writer claims no immunity).

My job is to provide readers with my own interpretation of the market trend. If it's a bear market, I will state that it is, and I will present my reasons for believing so. If the tide has turned, I will put forth my arguments in writing, and those who do not agree with me are free to write and tell me so (a not uncommon phenomenon). All this notwithstanding, I do not think I have ever written a page without recalling (with some trepidation) Hamilton's warning regarding "pride of opinion."

Many investors, of both large and small means, write to me asking for further assurances or statements of "certainty" regarding my bullish or bearish views. While recognizing that such letters may represent great agony and financial suffering on the part of the writers -- I feel that such letters are essentially unfair. I try to present the case as I see it. At times the evidence seems overwhelming, but most of the time the market presents a study in probabilities. "Quackery," wrote Rhea, "can usually be detected by positiveness of pronouncements. Those who have attained a bachelor's degree are never so cocksure."

In boasting about his 1961-62 market record, the irrepressible Major Angus (owner of a fine sense of humor) recently wrote: "And now, having told you how wonderful we have been, expect us to be wrong for the rest of our lives." A little later the Major exclaimed: "One of the best market tips that I know is to 'beware of all recently successful market tipsters.' Lady Luck doesn't like Lotharios who kiss and tell (about her embraces). She switches her favours to other less brash gallants." The Major has been around a long time; he's seen the "geniuses" come and go.

A DIFFICULT PERIOD The second leg of the bear market terminated on June 28, at 535.76 for Industrials, 115.89 for Rails. An upward correction then took Rails to a recovery high (125.49) on July 12, Industrials to their recovery high (616.00) on August 23. Following the recovery, Rails broke to a new bear market low of 114.86 on October 1. The new Rail low has not yet been confirmed by Industrials.

According to Dow's classic Theory, a trend is taken to remain in force until proved otherwise. In the present case, we must infer that a primary bear market continues. Furthermore, Dow's Theory stipulates that a penetration of one Average unconfirmed by the other is meaningless (and perhaps even deceptive). The fact that Rails broke to a new bear market low without confirmation by Industrials presents an interesting (but certainly not conclusive) picture.

In the majority of cases (during a bull or bear market), when one Average establishes a new primary high or low point, the other Average eventually confirms. In other words, the odds now favor an eventual Industrial penetration of the bear market low (535.76).

Nevertheless, it should be born in mind that a persistent refusal by one Average (in this case Industrials) to confirm the indications of the other can result in a secondary reversal -- and, on occasion, a primary reversal.

All of which boils down to this -- on an orthodox reading of the Averages, Dow Theorists (regardless of hopes or wishes) must infer that a bear market is still in progress. Full confirmation of that thesis will nevertheless require an eventual Industrial penetration of the bear market low (535.76). Moreover, since Rails have recently set a new bear market low below their June level, it will now take a joint penetration by both Averages below their recent lows (Industrials below 535.76, Rails below 114.86) to reconfirm the primary bear trend.

Readers should fully understand the following: Dow's Theory entails a great deal more than a mere "reading of the Averages." It concerns itself with yields, values, timing, phases, volume implications, and psychology. It has been (and still is) my opinion that we have not seen indications of the third and final phase of a bear market (depressed psychology, high average yields, indiscriminate "dumping" of high-grade stocks, public disinterest). Moreover, it is my belief that the price structure taken together with volume does not yet suggest the formation of a major bear market bottom.

The market itself will tell the final story -- I only attempt to follow the market and interpret its movements. Therefore, as an uncommited potential investor, the following thoughts are now running through my mind, and readers might as well hear them:

(1) On a "mechnical" reading of the Averages, if the two indicators push steadily higher on increasing volume and hurdle their secondary highs (Industrials 616.00, Rails 125.49) we will then have what appears to be a Dow Theory bull signal. Whenever both Averages establish secondary peaks, recede, then advance above those secondary peaks, the move usually carries considerably further in the direction of the penetrations. It is also true that the majority of such movements have signaled changes in the primary trend.

There have, nevertheless, been exceptions to this rule, and one important exception occurred during the year 1930 (see Letter 186). Following the 1929 crash, the two Averages rallied vigorously to peaks which were established in December, 1929. A three-week decline ensued, following which the two Averages pushed up again. In February, 1930, the Averages bettered their preceding 1929 secondary highs, and most observers took this to be the signal for a new bull market. It is interesting to note that once having bettered their 1929 secondary peak, Rails never rose appreciably higher, although Industrials rose from 263 (their 1929 secondary high) to 294 before "topping out." Volume on this rise was enormous (actually surpassing the volume at the 1929 peak), and many stocks embarked on spectacular advances. Some issues (such as motion picture stocks) actually rose to a new all-time highs.

Badly shaken by the deceptive 1930 rise, Rhea later wrote: "Hamilton had died in early December, 1929, and his comments on the Averages were badly needed, at least by this writer. His last discussion of the Averages appeared December 3, 1929, only a few days before his death. Prices were then nearing the preceding (1929) peaks. The editorial contained the following prophetic sentence: '....people assuming that the old bull market is to be resumed at once merely demonstrate that the wish is father to the thought'."

My personal suspicion is that if the two Averages now better their preceding secondary highs (and of course I am now disregarding all discussion of the Industrial Average-A-D ratio relationship), we will more than likely have a situation like 1930.

(2) One phenomenon which particularly bothers me about the total picture (from the bull standpoint) is as follows: the Industrial Average struck its bear market low on June 26, 1962, at 535.76. This was the last confirmed low point of the bear market (the later Rail low was, of course, not confirmed by the Industrial Average). If the Averages "take off" on a new bull market rise from here, history will record June 26 as the end of the bear market. Yet four months after that date (October, 1962 -- see Letter 198), the A-D ratio dropped to a new bear market low. In other words, the tendency of the majority of issues was downward for four months after the Industrials struck their low. If June represented the low point for the bear market, we will have witnessed unprecedented action on the part of the A-D ratio. In the case of all true bear market bottoms going back to 1932, the A-D ratio has always struck bottom before or coincident with the final low established by the Industrial Average -- never later. No true bull market has ever materialized from a situation wherein the Industrial Average struck a low while the A-D ratio (or general market) continued to drop. In other words, when "the tide turns", the A-D ratio should start moving slowly and relentlessly upward (as the great primary trend exerts its force on the entire market).

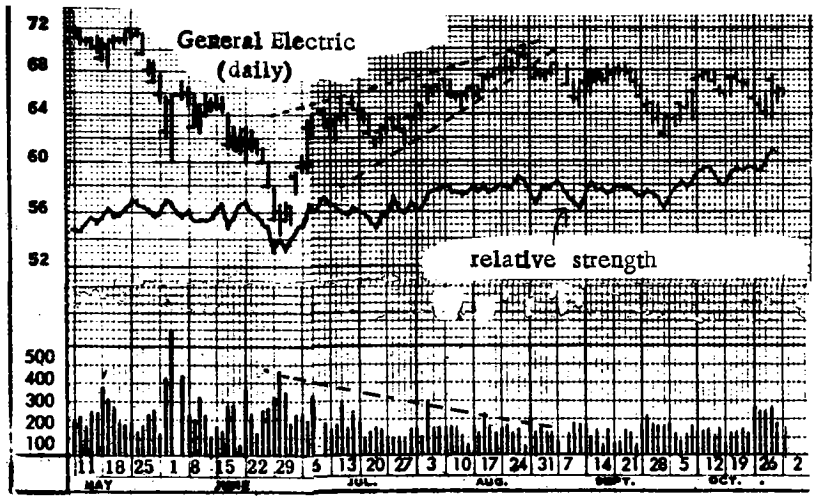
CONCLUSION: The primary trend continues bearish. The secondary trend is also bearish and will be considered bullish only if both Averages better their post-crash recovery peaks. The relationship between the Industrial Average and the A-D ratio is now bearish, and I would treat any declining action which may start from this area of triple divergence with the greatest respect.

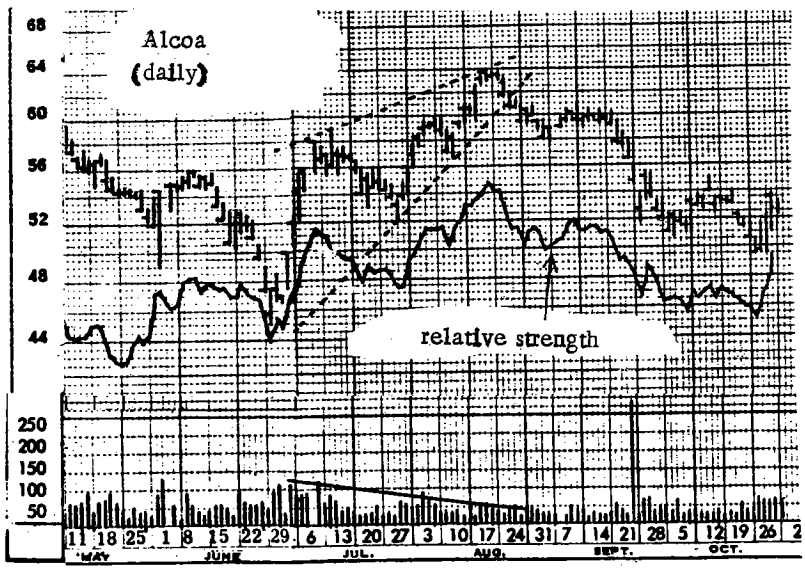
STOCKS As of Monday morning (October 29), 14 out of 346 representative stocks were holding above their 30-week moving averages (we compute these statistics each Monday morning). While the violent upside action of Monday and Tuesday undoubtedly took a number of additional stocks above their moving average, the total bullish count at this time is still woefully small.

The chart of Alcoa (AA) presents an interesting study. AA touched a bear market low of 45 in June (see chart on page 4). As mentioned in Letter 192, AA's rise from the June low took the form of an ascending wedge pattern. Such patterns are characteristic of bear market rallies -- not bull market bases. The wedge in AA was broken in August, whereupon the stock dropped

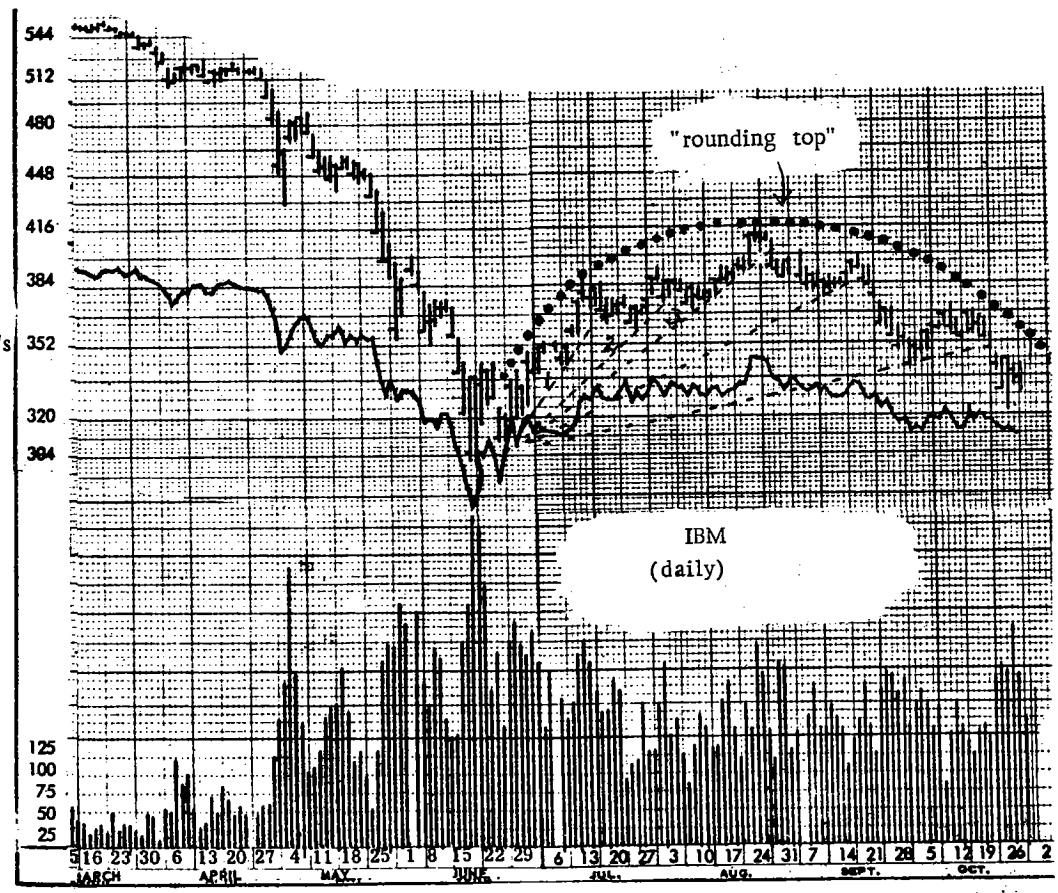
to 49 1/2. If I were bullish I would ask myself the following rather provocative question: if AA (a leading D-J Industrial component) did hit final "bottom" in June at a price of 45, is it logical to have the initial rise from the bottom assume the form of a rising wedge (which is a typical bear market rally formation)? In other words, at a true bear market bottom I would expect a stock like AA to form a reverse head-and-shoulders, a long "line", a triangle or a rounding bottom -- but not a rising wedge! Conclusion: Do not trust the June low for AA. The odds favor that low's being broken.

The rising wedge pattern was rather common during June to August, 1962, and I include another example, General Electric. Here we see a rising wedge starting at the June low, a break out of the wedge on the downside, then a sort of aimless sidewise movement. The fact is, however, that the pattern from which G. E. rallied was a typical bear market pattern. An added strange feature of G. E. is the little "reverse head-and-shoulders" pattern which appeared during September and October. This pattern has formed at the top of the rise, but such reversal formations should occur at the bottom of a decline. I have learned not to trust "reversal patterns" which appear where they should not appear. They are generally deceptive.





The unsatisfactory little "head-and-shoulders base" in IBM (the leading institutional holding) was examined in Letter 193. At that time I stated that volume implications were suspect, and that an application of the three-fan-line principle suggested that the stock was in trouble (stock was then selling at 384). IBM is now forming one of those amazingly symmetrical "rounding tops" so characteristic of distribution in high-grade issues (as contrasted with the violent reversal patterns usually seen in speculative issues at the top). Volume is tending to expand as IBM declines, and I still do not recommend "putting it away for the kids."



Late Market Notes (written Thursday, Nov. 1; noon, N. Y. time). Yesterday's 8¢ upward penetration of the October 15 Industrial peak gave us triple-divergence between the Average and the A-D ratio. Moreover, the penetration came on sharply reduced volume (a phenomenon which Rhea always considered suspect). Today the market sold off in the morning on reduced volume. If volume picks up as the decline continues, I would view the picture as very dangerous.

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